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S&PCORRECT: California GO Rating Raised To 'A+' Following A Spike In Revenues

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(**Editor's note:** In the media release published earlier today, the lease rating upgrade was expressed incorrectly in the second paragraph. A corrected version follows.)

NEW YORK (Standard & Poor's) May 17, 2006--Standard & Poor's Ratings Services today raised its rating on California's GO bonds one notch to 'A+' from 'A' based on a \$7.5 billion surge in combined fiscals 2006-2007 revenues over January projections, leading to higher-than-expected general fund balance levels estimated for fiscal 2006 and projected for fiscal 2007. This substantial increase in revenues has led the state to estimate a reduction in its structural deficit to \$2.5 billion, or 2.5% of expenditures, in fiscal 2007.

Concurrent with the GO upgrade, Standard & Poor's raised its rating on the state's lease-supported debt to 'A' from 'A-'.

The state's completed fiscal 2005 audit shows a slightly positive general fund balance at fiscal year-end, while projections indicate a budgetary basis general fund balance of more than 10% of expenditures at fiscal year-end 2006. Gov. Arnold Schwarzenegger is recommending the use of a large portion of increased revenues, suspected of being related to stock market and housing sale capital gains, on onetime expenditures. Nevertheless, his proposed budget still recommends a 9.1% increase in fiscal 2007 general fund expenditures and transfers, along with an operating deficit of 7.0% of expenditures--leaving reserves at \$2.2 billion, or 2.2% of expenditures, which is still higher than his \$1.1 billion ending reserve proposal in January.

"The improvement being seen in California can be traced back to strong economic growth in almost all sectors and geographic regions of the state, as well as a spike in stock market and housing-related capital gains tax revenues," said Standard & Poor's credit analyst David Hitchcock.

"California's inability to wholly eliminate its structural deficit despite prosperous economic conditions, however, remains a credit concern."

Debt levels could also rise to moderately high, although still manageable, levels if all authorized unissued debt is sold and voters approve \$37.3 billion of GO bonds on the November ballot.

The rating outlook is stable based on the state's solid near-term fund balances, which are offset by revenues and fund balances that have historically been volatile, coupled with out-year projections of continuing structural operating deficits.

There are reasons to believe the current surge in revenues could be of a onetime nature, which is a concern. In April the state received \$11 billion in personal income taxes, a high proportion of which was from taxpayers filing for extensions, who tend to be progressively taxed upper-income filers with more volatile income. In addition, capital gains tax revenues increased by 32% in fiscal 2005 with recent double-digit housing price increases and strong stock market gains being likely contributors to this increased capital gains tax income.

Gov. Schwarzenegger's proposal to spend down much of the state's fund balance in fiscal 2007 also constrains the rating, as does the substantial amount of deficit financing bonds remaining, which is almost equal to the estimated fiscal 2006 general fund balance. However, the governor is also proposing the use of about \$3.8 billion of the state's estimated \$101.0

billion of fiscal 2007 general fund expenditures for onetime purposes. In addition, he announced a plan to retire all deficit bonds by fiscal year-end 2009, including the repayment of roughly \$1.5 billion in fiscal 2007.

"The state's fiscal 2007 budget has not yet been adopted, and it remains to be seen whether the state will pursue fiscal discipline with its newfound revenues," said Mr. Hitchcock.

The rating action affects roughly \$39.6 billion of GO debt not additionally supported by sales tax, housing, or water revenues, along with about \$7.7 billion of lease debt.

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